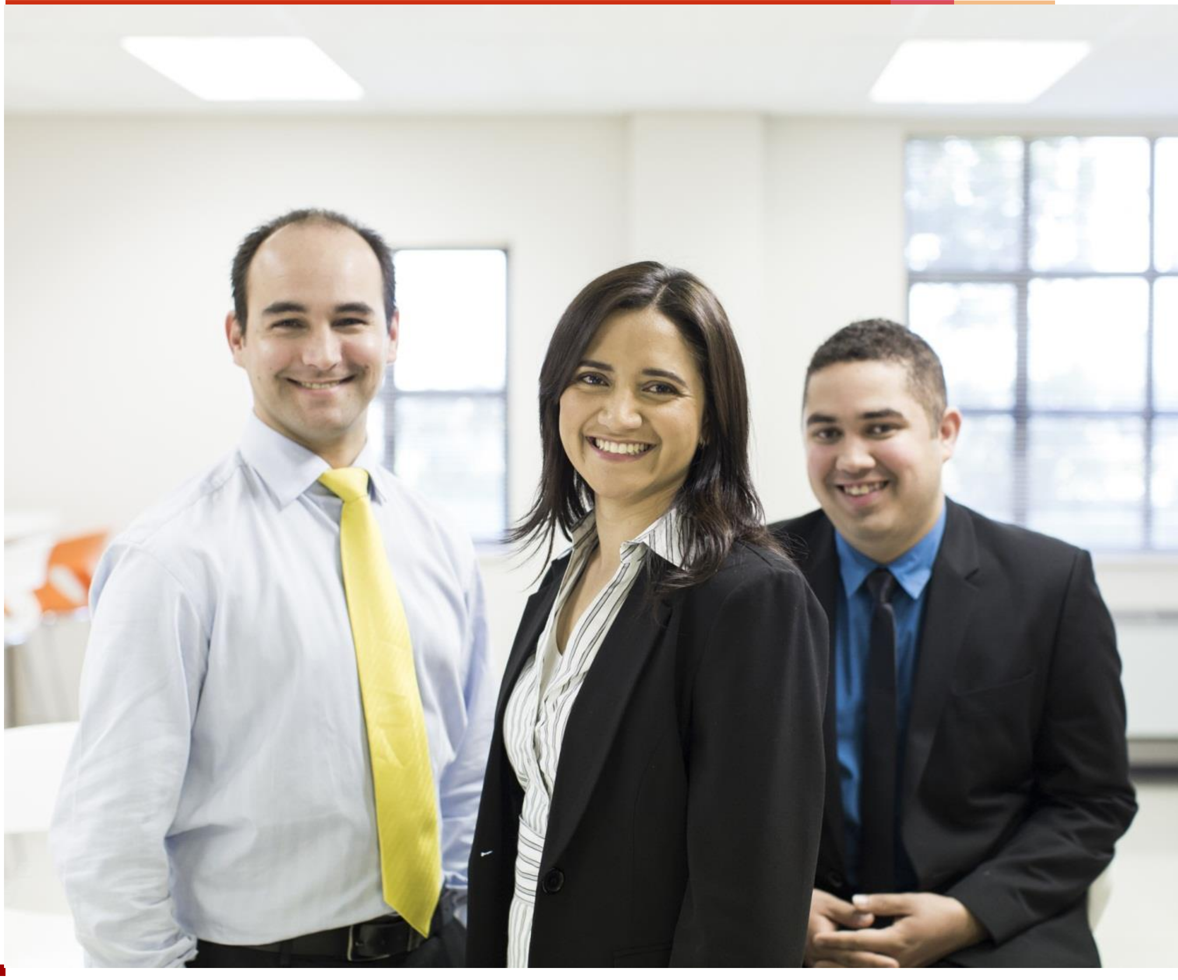
www.pwc.com

Value-based pricing

Putting the customer at the center of price



Value-based pricing: Putting the customer at the center of price

By Mark Haller and Avynash Gersappe

Companies have access to more data about their business than ever before. They're taking advantage of sophisticated analytics and an ongoing shift to digital sales and support channels to develop deep insights about their customers, their competitors, and their markets. So why aren't more organizations using these advanced analytics capabilities to spruce up outdated pricing models?

Pricing remains one of the immovable forces of product- and service-oriented companies transitioning to the digital age. For decades, a widely accepted formula has ruled pricing strategy: determine a base cost, then apply a standard markup you think the market will bear. This "cost-plus" method is frequently inefficient because the price either ends up too high, which hurts sales, or too low, which leaves money on the table. Cost-plus models are becoming even less effective in a global economy where price transparency is prevalent and products are increasingly commoditized.

Better alternatives are emerging, in large part because companies now have access to more data, which enables them to develop a deeper understanding of the characteristics of a product, service, or delivery channel that customers value the most. Leveraging these insights, companies can create "value-based" pricing models that calculate with far more precision what different groups of customers are truly willing to pay for specific products or services. Generally speaking, we've found that companies moving from a cost-plus to a value-based pricing model can often generate between 1% and 3% of revenue as incremental margin.

An unbiased definition of value

The simplest form of value-based pricing involves how customers use your product. Is the product unique in their eyes, relative to competitive offerings? If not, does it create some production efficiency for the customer? An automaker may value an industrial paint product because it has better dispersion and opacity characteristics than competitive brands, which allows the customer to paint 100 additional cars for every 1,000 gallons it uses. That characteristic justifies an extra $1 or more per gallon, because the automaker's total cost of ownership is lower.

This model can be applied to different customer segments, further fine-tuning your pricing strategy. An automaker may value your paint because of its chip resistance. A construction company might like the fact that it doesn't jam its paint guns. A contractor in a southern climate may place a premium on the paint's sun-protective characteristics. Identifying the truly unique attributes that core customer segments value will help you set pricing for products or product/service bundles that align with each segment's willingness to pay.

One thing's for sure: Only those who truly understand their customers and how they value the product or service, and then segment customers on that basis, can fully take advantage of this approach. Large/medium/small as a segmentation approach rarely cuts it anymore. Nor does the legacy view of, "We know our customers."

Instead, you need to tease out the value – not just by what customers say they value, but what they act on at a buying event. This may mean offering different promotions to customers on the web to gauge response, and respond in the retail environment. For B2B sellers, it may mean surveying customers. Whatever the manner, a deeper understanding of customers is vital to a successful value-based selling model.

Approaches and tools to discriminate on value

Knowing what constitutes value to your customers is just the first step; you still have to secure the sale. Price differences by segment or use case is one way, but other tools of value discrimination – including segment- and condition-based discounts, rebates, and promotions – are often required as well. Certainly, everyone uses these methods today. But with a better understanding of value and the objectives for capturing it, you can make these vehicles more efficient by deploying them where they do the most good – while discouraging the "wrong" customers from taking advantage of them.

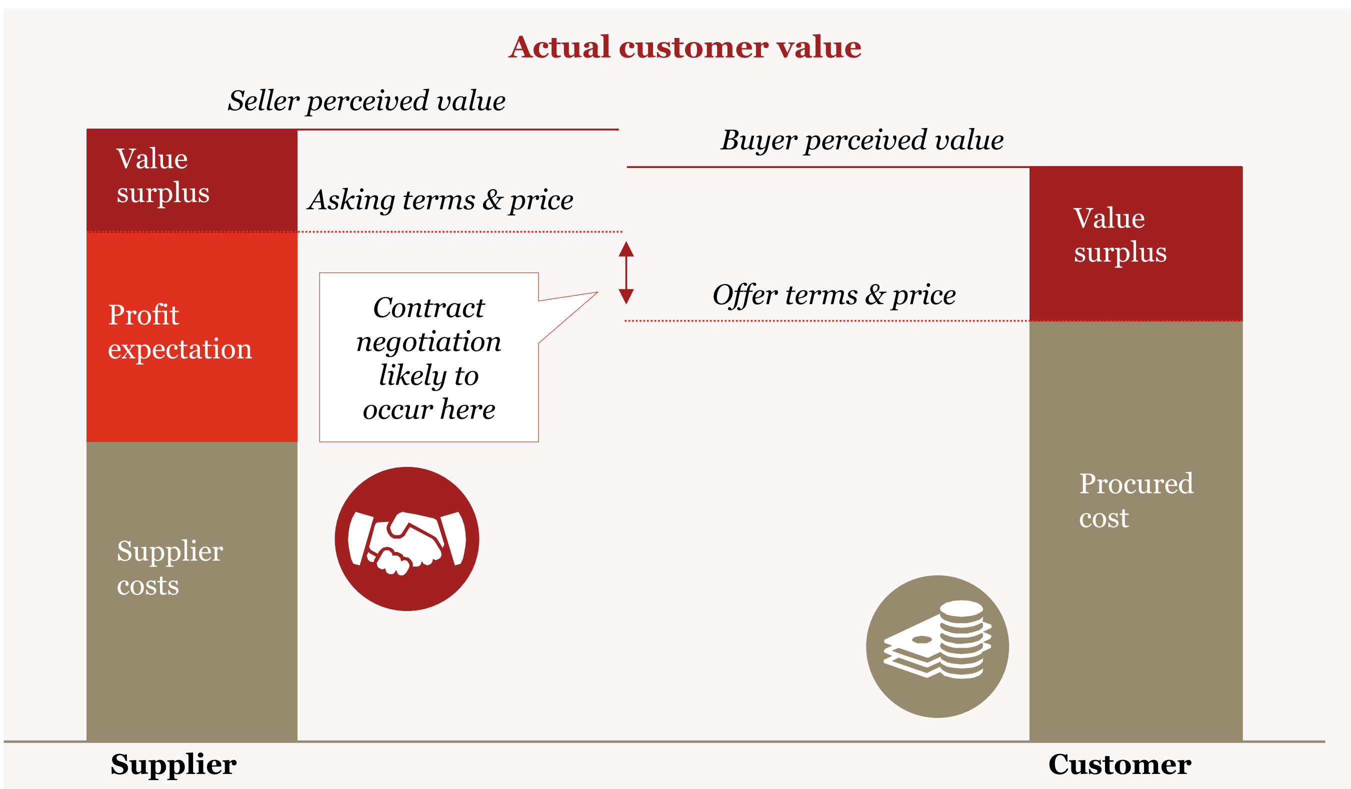
A quantifiable definition of customer value can be a real eye-opener for sales teams, who oftentimes place a premium on features that turn out to be table stakes – meaning that customers expect to receive them without paying extra. If you don't deliver those table stakes on their terms, they will punish you by taking their business elsewhere.

Value-based pricing gives sales teams the opportunity to shift the conversation with customers from price to value. The ability to talk about the attributes that customers value most – using data, not intuition or conventional wisdom – changes the tone of the buyer-seller relationship, giving brands a real opportunity to

differentiate their products and services from the customer's perspective. In addition to incremental revenue gains, this approach can increase satisfaction, loyalty, and retention – key drivers of long-term value.

Once you go deep into the data, you begin to develop an unbiased view of whether and what about your products is truly distinct in the eyes of your customers you have the basis for realizing real advantage. Almost every company talks about becoming more customer-centric. Value-based pricing is one of the more tangible ways to demonstrate that commitment.

How value-based pricing comes to reflect actual customer value



Getting started

The transition to value-based pricing generally requires three foundational elements:

- **Better segmentation:** Many organizations are already leveraging big data to move away from traditional demographic-based segmentation, incorporating transactional and behavioral information to build more sophisticated customer groups. You can then identify the product and service attributes that are most important to each segment, which becomes the baseline for value-based pricing.
- **Alignment with operational capabilities:** Too much granularity will complicate your ability to execute. Attempting to create variable pricing for 10,000 SKUs across dozens of customer segments can get out of hand quickly. Generally, defining five or six attributes will cover 80% of the variations in customers' willingness to pay.
- **Continuous testing:** Companies have come to rely on A/B testing for everything from website design to email marketing. Rapid prototyping is an effective way to build out your value-based pricing model as well. By offering different combinations of products or services to various customer segments at different price points, you can quickly determine how well your pricing aligns with customer value – and make adjustments on the fly.

About the authors

Mark Haller is a partner who leads PwC's Pricing & Profitability practice.

Avynash "Chico" Gersappe is a director in PwC's Customer Impact practice.